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SYSTEM AND METHOD FOR ASSISTING A BANK IN MEETING THE BANK'S INVESTMENT TEST REQUIREMENT UNDER THE COMMUNITY REINVESTMENT ACT

Field of the Invention

The present invention relates to systems and methods used by banks for meeting the investment test requirement under the Community Reinvestment Act.

Background

The Community Reinvestment Act (CRA) is intended to encourage depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income (LMI) borrowers and neighborhoods, consistent with safe and sound banking operations. The CRA was enacted by Congress in 1977 (12 U.S.C. 2901) and is implemented by Regulations 12 CFR parts 25, 228, 345, and 563e. The Regulation was revised in May 1995.

The CRA requires that each insured depository institution's record of helping to meet the credit needs of its entire community be evaluated periodically. That record is taken into account in considering an institution's application for deposit facilities (i.e., new branches), including mergers and acquisitions. CRA examinations are conducted by the federal agencies that are responsible for supervising depository institutions: the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). These agencies comprise the Federal Financial Institutions Examination Council or FFIEC.

The four federal agencies approved examination procedures to implement the revised Community Reinvestment Act (CRA) regulations that were published in the

Federal Register on May 4, 1995. There are four sets of procedures -- procedures for small institutions, for large retail institutions, for wholesale and limited purpose institutions, and for institutions that have been approved for evaluation under a strategic plan. The four different procedures correspond to the four alternative evaluation methods provided in the revised CRA regulations and are designed to respond to basic differences in institutions' structures and operations.

In summary, the CRA regulations measure how successfully an institution meets the community development and credit needs of its assessment area (geographic operating "footprint") through lending, investments, and service. For large retail institutions, defined as those with greater than \$250Mil of assets (proposed to increase to \$500Mil), the test weightings are 50%, 25%, and 25%, respectively.

The federal agencies have provided answers to numerous questions pertaining to the provisions and topics of the CRA regulations. The OCC, on behalf of the other FFIEC members, published a series of Interpretive Letters soon after the release of the revised regulations in 1995. An official <u>Interagency Q&A Regarding Community Reinvestments</u> notice was published in the Federal Register on July 12, 2001 and the number of Interpretive Letters on the CRA has since slowed dramatically.

The CRA regulations define community development, qualified investments and other terms to guide regulated institutions in their compliance. Some of the key definitions in the regulations include:

"Qualified Investment" means a lawful investment, deposit, membership share, or grant that has as its primary purpose community development.

"Community development" means: (1) affordable housing (including multifamily rental housing) for low- or moderate-income individuals (LMI); (2) community services targeted to low-or moderate-income individuals; (3) activities that promote economic development by financing businesses or farms that meet the size eligibility standards of the Small Business Administration's Development Company or Small Business Investment Company programs (13 CFR 121.301) or have gross annual revenues of $1 million or less; or (4) activities that revitalize or stabilize low- or moderate-income geographies.

"Income level" includes: "Low-income", which means an individual income that is less than 50 percent of the area median income, or a median family income that is less than 50 percent, in the case of geography; "Moderate-income", which means an individual income that is at least 50 percent and less than 80 percent of the area median income, or a median family income that is at least 50 and less than 80 percent, in the case of a geography. (Thus low-to-moderate income (LMI) includes individuals whose income is less than 80 percent of area median income, or median family income that is less than 80 percent, in the case of a geography.)

"Area Median Income" means the median family income for the MSA (Metropolitan Statistical Area), if a person or geography is located in an MSA; or the statewide non-metropolitan median family income, if a person or geography is located outside of an MSA.

The Interagency Q&A and Interpretive Letters make it clear that qualified investments may be held directly or indirectly (i.e., via a fund) and still receive favorable CRA consideration. The Q&A and OCC Interpretive Letters specifically confirm that

mortgage-backed securities (MBS) backed by loans made to low-to-moderate income borrowers are qualified CRA investments because they promote affordable housing for LMI individuals. As an approved CRA investment, Fannie Mae, Freddie Mac and several large banks make a market in taxable CRA-targeted MBS and collateralized mortgage obligations (CMOs), selling them to banks, funds, and other investors.

Bank owned life insurance (BOLI) is life insurance owned by banks on the lives of executives and directors. BOLI is regulated by the OCC (and OTS, FRB, and FDIC) through a series of Banking Circulars (249) and Bulletins (96-51 and 2000-23) which provide guidance to ensure that bank purchases of life insurance are consistent with safe and sound banking practices. Banks typically purchase BOLI to cover the loss of key employees and to help manage human resource liabilities such as nonqualified pensions and post-retirement welfare benefits.

Since it is life insurance, BOLI enjoys tax-deferred cash value growth and tax-free death benefit proceeds. Further, the generally accepted accounting principles (GAAP) treatment for life insurance requires that the cash value be carried on the balance sheet and thus the growth in cash value is recognized in current earnings. The current cash surrender value (CSV) is reported in Other Assets and the periodic increase in CSV is reflected in book income.

The insurance industry offers several types of policies to address customer preferences regarding liquidity (Modified Endowment Contract (MEC) vs. Non-MEC), volatility (Guaranteed return vs. Mark-to-market), and credit risk (General Account vs. Separate Account). Larger institutions have historically preferred the improved credit risk and investment flexibility inherent in Separate Account policy designs. Most large

BOLI purchases have been single premium MEC policies that will be held until the death of the insured employee; implying a 40+ year holding period. Presently, the ten largest U.S. banks which own BOLI collectively own over $40 Billion of cash value recorded on their balance sheets, and most of it is in Separate Accounts.

Separate account life insurance permits the policy owner to direct how the cash value is invested. The portfolio management of the account is provided either by the insurance company or a third-party investment advisor. The OCC defines which permissible bank-eligible investments may be held within life insurance; generally such investments are limited to government guaranteed or highly rated fixed-income securities. Thus, most Separate Account BOLI is invested in portfolios of U.S. Treasury and Agency securities; MBS guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae; and other high-grade fixed income securities.

As explained more fully below, the present invention provides a mechanism whereby a bank can enjoy the tax benefits and other advantages of Separate Account BOLI while, at the same time, assisting the bank in meeting its investment test requirement under the CRA.

Summary Of The Invention

The present invention is directed to a system and method for assisting a bank in meeting all or a portion of the bank's investment test requirement under the Community Reinvestment Act (CRA) on a tax-advantaged basis. New or existing cash value life insurance policies owned by the bank on the lives of employees of the bank are provided, wherein the policies designate the bank as owner and beneficiary. The assets which

support the cash value of the life insurance policies are maintained in a separate account that is protected from general creditors of an issuer of the life insurance policies. The assets in the separate account are used to purchase one or more bank-eligible securities that are qualified investments, and which promote community development as defined under the CRA.

As the value of the assets in the account grow, the bank owner(s) of the policies which participate in the separate account, report the income on its/their balance sheet(s) and through its/their income statement(s). The value of the CRA investments is recognized for book purposes (GAAP), but not for tax purposes because it is held in life insurance (i.e, it is tax-advantaged). Specific qualified investments (or portions thereof) in the separate account are attributed to each bank investor to satisfy the geographic requirement of the investment test under the CRA.

In one embodiment, the separate account includes only assets supporting the cash value of the life insurance policies provided to the bank (single client or customer specific separate account). In an alternate embodiment, the separate account includes assets supporting the cash value of life insurance policies provided to a second bank. In one variation of this alternate embodiment, the separate account may only include assets from life insurance policies issued by a common issuer (commingled separate account). In a different variation of the alternate embodiment, the separate account includes assets from life insurance policies issued by different issuers (registered separate account that permits mixed and shared funding).

Various securities that are qualified investments under the CRA may be purchased using the assets in the separate account including "targeted" mortgage-backed

securities (MBS) or collateralized mortgage obligations (CMO) issued or guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae that provide affordable housing. Such MBS and/or CMO may be backed by single family residential loans to low-to-moderate income (LMI) borrowers; alternatively, such MBS and/or CMO may be backed by multi-family residential loans made on projects which are eligible for the Low Income Housing Tax Credit (LIHTC). Other qualified investments could include: "Private label" MBS or CMO backed by loans to LMI borrowers or LIHTC projects; taxable state housing authority bonds; certificates of deposit (CD) issued by Community Development Financial Institutions (CDFIs) and guaranteed by the FDIC; community development loan pools guaranteed by the US Government and its agencies; and warehouse lines of credit for originators of LMI mortgages.

Brief Description of the Figures

Figure 1 is a flow diagram illustrating a method for assisting a bank in meeting its investment test requirement under the CRA.

Figure 2 shows a computer-implemented system for assisting one or more banks in meeting the investment test requirement under the CRA.

Detailed Description of the Preferred Embodiment

Referring now to Figure 1, there is shown a flow diagram illustrating a method for assisting a bank in meeting its investment test requirement under the CRA, in accordance with one embodiment of the present invention. More particularly, Figure 1 illustrates

how a CRA-BOLI separate account may be used to fund single- and multi-family residential mortgages for LMI borrowers and LIHTC developers.

Lenders 10 originate single- and multi-family residential mortgage loans that promote affordable housing and community development. Such loans may be mortgages to low- or moderate-income (LMI) borrowers 12, or loans to LIHTC developers 14 for the construction and permanent debt financing of LIHTC affordable apartment developments.

One or more aggregators 16 (alternatively, some lenders are Delegated Underwriters or Authorized Issuers who may securitize their own loans into MBS which contain a guarantee from Fannie Mae, Freddie Mac, or Ginnie Mae) pool and securitize the loans into securities (e.g., MBS) for sale to institutional investors. Examples of aggregators include Fannie Mae, Freddie Mac, and Countrywide. The securities generated by aggregators 16 constitute "qualified investments" under the CRA (i.e., investments that may be used to satisfy an institution's investment test requirement under the CRA), and have as their primary purpose community development. The securities can be sold directly to banks 20, insurance companies 22, or pension funds 24. The securities can alternatively be sold to portfolio managers who purchase the MBS on behalf of investors in a mutual fund or insurance separate account 26, as discussed below.

Separate account 26 contains assets that support the cash value of one or more BOLI contracts owned by Bank 32 on the lives of employees of Bank 32, wherein the BOLI contracts designate Bank 32 as beneficiary. Separate account 26 is protected from the general creditors of the issuer(s) of the BOLI contracts associated with the account. In the embodiment shown, separate account 26 also contains assets that support the cash

value of one or more BOLI contracts owned by Bank 34 on the lives of employees of Bank 34, wherein the BOLI contracts designate Bank 34 as beneficiary; and separate account 26 contains assets that support the cash value of one or more BOLI contracts owned by Bank 20 (that is, the same Bank as above where purchase is direct) on the lives of employees of Bank 20, wherein the BOLI contracts designate Bank 20 as beneficiary. Although in the embodiment shown, separate account 26 contains the assets of BOLI contracts from different banks, it will be understood by those skilled in the art that a customer-specific separate account (i.e., a separate account that contains the assets of BOLI contracts from a single bank) could also be used.

Referring still to Figure 1, the BOLI cash value contained within separate account 26 is used to purchase qualified investments under the CRA (created by aggregators 16), thereby allowing Banks 32, 34, 20 to make bank-eligible investments (i.e., securities which a bank may hold as defined by banking regulations 12 USC 24 and 12 CFR 1) which garner CRA consideration, while at the same time, allowing the banks to take advantage of the tax-advantaged treatment afforded to life insurance (i.e., investment return is not presently taxable because of the tax treatment afforded to life insurance under the Internal Revenue Code). In one embodiment, a portfolio manager associated with separate account 26 uses the assets in the separate account to purchase MBS that constitutes a qualified investment under the CRA from aggregators 16. The MBS purchased through separate account 26 are then attributed to the banks which participate in the separate account. Specifically, the portfolio investments are analyzed at the loan level detail and reported by the fund manager to the various investors based on their assessment area(s). The loan level detail of each MBS pool comes from the aggregator or

guarantor of the MBS and includes the property address, income level of the borrowers relative to the area median income, etc. so that the "LMI" designation can be verified. Each bank 32, 34, 20 reports the amount of qualified investments attributed to the bank during the examination period to the CRA examiner. The examiner determines whether or not the investments receive favorable consideration under the CRA.

In a particular embodiment, the investment guidelines of the separate account may permit the portfolio manager to purchase MBS at a price that buys down the rate to the primary market borrower. For example, the net after-tax yield of a standard MBS (6.0% assumed gross taxable yield = 3.6% net after-tax, in a 40% tax bracket) can be matched at a much lower rate in BOLI (4.5% gross = 3.6% net of all insurance charges). The real value from a community development and affordable housing perspective is that the loan rate to the borrower in this example can be 1 to 1.5% below market. Understandably, this result is conditioned on the BOLI investor accepting the lower tax-equivalent yield and finding a primary market lender to originate the below market loans, securitize them into MBS and sell the security to BOLI separate account 26.

As mentioned above, various securities that are qualified investments under the CRA may be purchased using the assets in separate account 26 including, for example, CRA-targeted mortgage-backed securities (MBS) or collateralized mortgage obligations (CMO) backed by loans made to low-to-moderate income borrowers, or CRA-targeted MBS or CMO backed by loans made for multi-family affordable housing. State housing authority bonds and Private-label CRA-targeted mortgage-backed securities or CMO may also be used.

Figure 2 shows a computer-implemented system 200 for assisting one or more banks in meeting the investment test requirement under the CRA. Figure 2 may be used to implement the method shown in Figure 1. System 200 contains a network 202 (e.g., the Internet, LAN, WAN or Intranet), which is used to provide communication links between various devices and computers connected together within system 200. In the depicted example, personal or network computers 204, 208, 210 and servers 206 are connected to network 202.

Computers 204 correspond to workstations with application software, and are used by mortgage lenders 10 for communicating electronically with aggregators 16 in order to facilitate the loan aggregation process. Servers 206 are maintained by aggregators 16 and include software for communicating with mortgage lender workstations 204. In addition, servers 206 have application software that is used to make an electronic market for the CRA-targeted MBS marketed by aggregators 16. Direct investors 20, 22, 24 and the manager of separate account 26 participate in the electronic market via workstations 208, which include application software for purchasing CRA-targeted MBS from aggregators 16 in the electronic market. Banks A, B, C use workstations 210 to communicate investment preferences to separate account workstation 208, and separate account workstation 208 communicates to workstations 210 information about how the CRA-targeted MBS purchased by the separate account 26 will be attributed to the banks.

Finally, it will be appreciated by those skilled in the art that changes could be made to the embodiments described above without departing from the broad inventive concept thereof. It is understood, therefore, that this invention is not limited to the

particular embodiments disclosed, but is intended to cover modifications within the spirit and scope of the present invention as defined in the appended claims.